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Author:

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Title:

Leasehold insurance

Place:

[New York]

Date:

[1920]

95-82490-7

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Leasehold insurance: an address delivered
before the one hundred and fifty-second meeting of
The insurance society of New York, on Tuesday,
January 26th, 1920, by George G. Hooper. [2d ed.,
[New York] Hooper [1920]
15 p. 23 cm.

Bibliography, 1 p. following p. 15.

RESTRICTIONS ON USE:

TECHNICAL MICROFORM DATA

FILM SIZE: 35mm

REDUCTION RATIO: 12x

IMAGE PLACEMENT: IA IIA IB IIB

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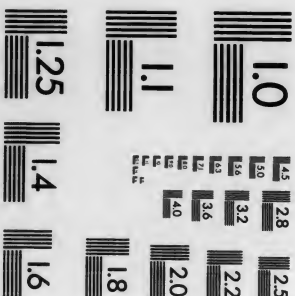
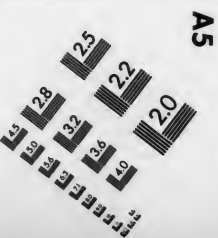
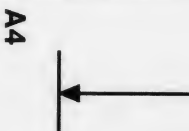
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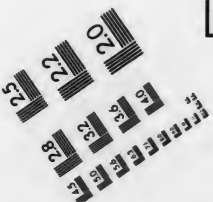
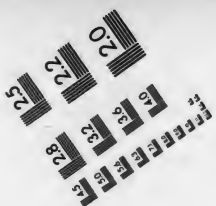
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Leasehold
Insurance

D816—H766

D816 H766

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LEASEHOLD INSURANCE

AN ADDRESS

*Delivered before the one hundred
and fifty-second meeting of*

The Insurance Society of New York
on Tuesday, January 26th, 1920

by

GEORGE G. HOOPER
SCHOOL OF BUSINESS

□

B

DARBY, HOOPER & McDANIEL

5. 18. 1871.

Brown

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INTRODUCTION

IT IS a matter of some regret to me that the topic for this afternoon was not assigned to some one whose experience extends beyond the local field.

But, as you all know, our secretary has set us such an example of zeal and devotion to the interests of the Insurance Society that one would feel ashamed to refuse any service that he might request and I am glad to make a small partial payment on account of the debt that I personally owe to the Society.

Leasehold Insurance

Gentlemen :

It is as true in the insurance business as in any other human activity that knowledge is the result of experience. The interpretation of the fire insurance contract in its application to the actual circumstances of numberless claims has built up a body of law and of practice by which we are guided in our conduct of the business.

There are probably few subjects of equal importance connected with the business concerning which there is less formal information or instruction than that of Leasehold Insurance. This is due in part to the fact that the serious losses have been comparatively few and litigated claims quite rare.

For this reason this paper is offered in full appreciation of the fact that it is only an attempt to combine in one more or less comprehensive discussion the rather fragmentary statements of a few writers and the views of some of our underwriters and loss adjusters who have been interested in the subject.

Many possible variations that are not directly discussed will occur to you, but it is hoped that the general principles will be made sufficiently clear to point the way to the solution of each particular problem.

The practice of insurance against loss by fire was for many years largely confined to the protection of visible property, such as buildings, household goods, merchandise, machinery, appliances, etc., but with the growing recognition of the advantage of insurance there has come about an increasing demand on the part of the public for protection against incidental losses resulting from

the destruction of the building, the loss of anticipated profits to the merchant on his stock of goods, the loss of the opportunity of profitable production to the manufacturer, the loss of anticipated commissions to the selling agent or factor.

These incidental losses are no less real than the property losses, but they may be more difficult to estimate or appraise and when insured the contract will usually contain some rule by which the loss is to be measured. Rent insurance is usually based on the annual rent of the building and only a pro rata proportion is collectible for the term between the date of the fire and the time when the building could with ordinary diligence be restored. Commission or Profit insurance usually fixes an agreed percentage to be paid either on the sound value of the goods damaged or destroyed or on the amount of loss to merchandise as finally adjusted. Use and Occupancy or Business Interruption insurance usually fixes a per diem loss of $1/300$ th, or other named fraction of the total amount of insurance for each day of total interruption or production.

One of the incidental losses which may be and often is sustained is the loss of use by a lessee of the premises leased to him, insurance against which is the subject of our present consideration.

A Lease is a conveyance of lands or tenements, usually in consideration of rent, for life, for years or at will, but always for a less term than the lessor has in the premises.

While a lease may be for an indefinite term (for life or at will) we shall consider only the lease for a definite term, as it would be difficult if not impossible to determine the value of a lease in the absence of a definite term.

When *unimproved property* or *land* is leased and such improvements as may be made are at the cost of the lessee, the lease is not usually terminated by destruction of, or damage to the improvement. In such a case the lessee has the right to insure his improvement and to replace it. He suffers also an interruption of his use exactly as the lessor or owner would if he had made the improvement and can insure his rents under the usual forms of rent insurance.

When the leased premises consist of or comprise an improvement or building or a part of it, the building remains the property

of the owner or lessor and the lessee has an insurable interest in the value of his lien for occupancy, but he has no interest in the building.*

If a lease of improved property is not terminated by the destruction of the building by fire or otherwise and the lessee is required to continue to pay rent without interruption, that loss also is properly covered by rent insurance.

An insurable leasehold interest exists whenever some additional valuable consideration has been paid for its possession, over and above the considerations stipulated in the lease, or whenever any expenditure for improvements has been made or whenever the possession of a lease results in a profit to the lessee, and when in either of these cases (or in any combination of them) the occurrence of a fire would terminate the lease and cause a loss to the lessee of the purchase price or bonus, or of his investment in improvements or of his prospective profit or all of them together.

It may be well to point out here that the profit to be derived from conducting a business is something separate and distinct from the earning power of the premises as real estate, and that, properly speaking, leasehold interest has to do with the earning power of the real estate. The conducting of any business is not necessarily limited to a specific location.

The profitable use of the means of production or service may be interrupted or destroyed, but can be restored or duplicated elsewhere in time. "Use and Occupancy" or "Business Interruption" insurance covers such losses and usually assumes one year as the maximum time necessary for such restoration or duplication. But when a long term lease yielding an annual profit to the lessee is terminated for any cause, the lessee's loss is final and total. The building may be restored or rebuilt by the owner, but he will then rent the premises on the basis of current rental values and himself enjoy the advantages of higher rental, which the lessee previously had.

A possible exception might be made in the case of "good will" when that depends on the location of the business rather than on the name or reputation of the lessee or on the character of the article he sells. If the location is peculiarly adapted to the

*Griswold, Fire Underwriters' Text Book, 689.

business and no other location can be secured, the good will of the business will be lost by the cancellation of the lease.

The value of the good will is difficult to determine, is largely involved with the activity of the individual and is possibly subject to exaggeration. To the extent that it can be defined it may properly be insurable, but should be written with caution.*

It would seem to be a reasonable assumption that, at the time of the signing of a lease, the amount of rent or other consideration paid is the full rental value and that there can be no definite or insurable profit to be gained by the lessee from the possession of the lease as such, but it is even then quite possible that the lessee may have secured the premises for less than actual value, through the ignorance of the lessor, or owing to his pressing necessities or for other reasons. In such cases there may be an actual prospective profit from the beginning.

The true measure of the value of the leasehold is the difference between the consideration paid for the premises and the actual net rental value to the lessee. The consideration paid may be an agreed rent of so much, monthly, quarterly or annually; or there may be in addition to the fixed rent, an obligation to pay taxes, interest, water rent and other maintenance charges, and possibly an agreement to improve the property in some specified way or by the expenditure of a specified amount—all of these items taken together make up the sum of the rent paid.

The rental value to the lessee, if he occupies the premises himself, is the amount for which the premises could be sublet, or the amount which he would be obliged to pay for the same space in an equally good neighborhood and under equally desirable conditions. If the premises are rented to sub-tenants, then the amount of rent actually received would establish the rental value of the premises, or, if a portion is occupied by the lessee and the rest sublet, then the rental value of his own space should be added to the rent received from his sub-tenants.

There is usually a fairly well-established standard of rental values and any qualified real estate agent or operator will be able, from his general knowledge of conditions, to estimate the value in any given case and furnish a check on the lessee's estimate where any part of the premises is occupied by the lessee.

*Eastern Underwriter, 9-29-16.

From this rental value when ascertained there should be deducted such maintenance charges, other than those required by the lease, as would be suspended or terminated by the untenable condition of the premises.

Having established the net annual rental value of the premises, there should be deducted the amount of annual rent in whatever form it may be paid by the lessee and the remainder is the lessee's annual profit, or in other words, the annual value of his leasehold interest. If the lease has more than one year to run, the annual profit should be multiplied by the number of years in the unexpired term of the lease to arrive at the total value of the leasehold. If the lease gives the lessee the option of a renewal for a further term or terms, then the annual profit may be multiplied by the full number of years to the end of the extended term. If the renewal privilege can be exercised only by the payment of an increased rent, the calculation must be made for the renewal term on the basis of that increased rent.*

All of this is equally true whether the leased premises consist of an entire building or only a part of it, and applies not only to the original lessee, renting from the owner, but also to each of the persons to whom he may sublet all or a part of the premises leased by him, and in turn to their sub-tenants, so that an insurable leasehold interest may be possessed at the same time by a series of tenants and sub-tenants.

Cases like the following are of actual occurrence:

"A" rents a certain building for \$5,000 a year for twenty years: at the end of the first year "A" sublets to "B" for \$6,000 a year for the remainder of the term (19 years at \$1,000.) "A's" prospective profit.....\$19,000
Four years later "B" sublets to "C" for \$8,000 (15 years at \$2,000). "B's" prospective profit..... 30,000
Five years later "C" sublets to "D" for \$10,000 (10 years at \$2,000). "C's" prospective profit..... 20,000
Each of these lessees—"A," "B" and "C"—has an insurable interest in the lease he holds for the amount indicated.

Such value as the leasehold has may have been created in one or more of the following ways:

*Griswold, Fire Underwriters' Text Book, 275.

1. The lessee may have improved the building in appearance, in convenience or in size by the expenditure of money or labor. He may charge up the outlay as a part of his rent, writing off a ratable proportion each month during the term of his lease, or he may insure his interest in such improvements separately. Sometimes a wise expenditure for improvements will add to the rental value out of all proportion to the amount so spent. It frequently happens that the owner is without the resources to make such improvements himself or lacks the imagination to devise or the confidence or initiative to make a profitable improvement. Or the property may be an estate which for various reasons is so involved or tied up that no expenditures can be made on improvements.

Successful real estate operators recognize opportunities which are overlooked by others, and having the courage of their convictions, they have the spirit and energy to carry their plans to a successful realization.

2. The character of the neighborhood may have improved by the erection of new buildings, attracting a higher class of tenants or changing the course of traffic. (The erection of the Pennsylvania Railroad Station at Seventh Avenue and 32nd Street in this City does both and will gradually revolutionize that section. Real estate values increased instantly and largely from the moment the project became known. The most conspicuous result up to the present time is the Pennsylvania Hotel.)
3. By the shifting of a business centre. Merchants in a given line of trade as shoes, woolens, crockery, hardware, leather, tend to keep together, and when one or two leaders move to an entirely new locality, attracted by larger space and lower rent, the others are likely to follow. (The Fifth Avenue shopping district in New York is a good illustration of this; also the wholesale silk business, relocated in the neighborhood of Fourth Avenue and 23rd Street.)
4. New or improved transportation facilities like the construction or extension of surface, elevated or subway car lines increase the rental value of all property affected.
5. An increased population, attracted by some new and large industry, creates greater housing and trading demands.

6. The natural growth of the population, which is one inevitable factor that must be taken into account in every large city.
7. An increased cost of building materials or labor, or both, immediately enhances the value of all existing structures. At the present time this condition affects, in some degree, all rental values, and probably every lessee in all the large centres, whose lease was made a year or more ago, could demonstrate an insurable leasehold interest. If he occupies the leased premises himself, he knows he cannot secure equivalent accommodations except for a substantial increase over the amount he now pays. If he sublets, he has already raised his rents or will do so as soon as the leases fall in.

Having considered the various ways in which a leasehold interest may be acquired or augmented, we will now see whether that interest may become impaired, and how.

All of the conditions which have been discussed, as adding value to a leasehold, may be reversed. The building may deteriorate from the lack of necessary repairs; the erection of adjoining buildings may shut off light or air or bring undesirable tenants or processes; a trade centre may move away; transportation facilities may be reduced or discontinued; population may be attracted to other more desirable localities; reduced labor and material costs may result in the erection of newer and better buildings which can be profitably rented at a lower range of rents. All of these conditions have been experienced at various times and in various places, and the lessee can only feel assured of his prospective profit for the period for which he has actually sublet at a profit, and even then the insolvency of his tenants may oblige him to secure others on a less profitable basis, or possibly on terms that involve him in an actual loss. There is a speculative factor in all such transactions that must not be disregarded or disappointment or even disaster may follow.

The terms of the contract itself as it bears on the security of the lessee in the enjoyment of his lease must also be considered.

The lessee undertakes to do certain things and to refrain from doing other things, and a default on his part may enable the lessor to terminate the lease in accordance with its conditions.

Fire, flood, earthquake, war or insurrection may result in the destruction of the building or render it untenable—and every

properly drawn lease provides what effect such occurrences shall have on the contract, and in the absence of some provision, the law of the land, either the common law or some statutory provision, will determine.

At common law and in any State in which the common rule has not been changed by statute, a lessee must pay rent during the term whether the building is destroyed or not, unless some clause in the lease expressly provides to the contrary.*

Under this rule (the common law) the land was considered the most important part of the leased premises and the lessee was bound to go on paying rent even after destruction of the building.**

The New York Statute is as follows: "When any building which is leased or occupied is destroyed or so injured by the elements, or any other cause, as to be untenable and unfit for occupancy, and no express agreement to the contrary has been made in writing, the lessee or occupant may, if the destruction of injury occurred without his fault or neglect, quit and surrender possession of the leasehold premises, and of the land so leased or occupied; and he is not liable to pay the lessor or owner rent for the time subsequent to the surrender."

The New Jersey Statute is as follows: "Whenever any building or buildings erected on leased land shall be injured by fire without the fault of the lessee, the landlord shall repair the same as speedily as possible, or in default thereof, the rent shall cease until such time as such building or buildings shall be put in complete repair; and in case of the total destruction of such building or buildings by fire or otherwise, the rent shall be paid up to the time of such destruction, and then, and from thenceforth, the lease shall cease and come to an end; provided always that this section shall not extend to or apply to cases where the parties have otherwise stipulated in their agreement of lease."

The clause in a lease which defines the status of the contract in the event of fire is commonly called the Fire Clause and in the most frequent form will read about as follows: "In case the building erected upon said premises shall be partially damaged by fire, the same shall be repaired as speedily as possible at the ex-

*N. Y. Journal of Commerce, 8-10-06.
**N. Y. Journal of Commerce, 10-13-10.

pense of the landlord, and in case said damage shall be so extensive as to render the building untenable, the rent shall cease until such time as the building shall be put in repair, but in case of the total destruction of the building upon said premises by fire or otherwise, the rent shall be paid up to the time of such destruction, and then and thenceforth this agreement shall terminate, provided, however, that such damage or destruction be not caused by the negligence of Tenant."

There are many variations from this form, of which a few examples are given: "If fire shall occur in the premises, the landlord shall have the option of terminating the lease." "If the building shall be damaged to the extent of 25% (or other fixed percentage), the lease may be terminated at the option of the landlord." "If the premises shall be rendered untenable, the lease shall terminate." "If the building shall be so damaged that the landlord shall decide not to repair." "If the building shall be so damaged that the landlord shall decide to rebuild." Each of these provisions creates the possibility of a termination of the lease. Some specified extent of damage or destruction either terminates the lease or gives the lessor or the lessee the option of doing so.

Too much confidence must not be placed in the words "totally destroyed." The courts have held that total destruction, within the meaning of the contract, is accomplished when the damage is so extensive as to necessitate substantially the rebuilding of the premises.

Whenever the lessor has an option to exercise, it may be confidently assumed that in proportion as the lease is valuable to the lessee, the lessor will be anxious to break it, and when the language is loose or indefinite, the lessor will endeavor to secure an interpretation of the clause that will be most advantageous to him. The present condition of high rental values due to the shortage of buildings is certain to result in efforts to cancel leases that in normal times would not be disturbed.

We have seen that a lease may acquire a value in excess of the amount of rent paid, that such value over a period of years in a long term lease may amount to a considerable sum, that the occurrence of a fire may terminate the lease and thereby cause an actual loss to the lessee of his prospective profit, and that profit becomes a proper subject of fire insurance.

The examination of a considerable number of leases justifies the belief that possible future value is rarely given any consideration whatever at the time the lease is prepared, due no doubt, to the fact that most leases are made only for occupancy, and very few with a definite view to profit for the lessee, and in those cases the lessee may fear to disclose his expectations until the lease has been secured.

As a result, the only protection for the owner of a valuable leasehold in the event of fire is to carry adequate insurance.

As fire insurance underwriters, we are interested in developing a demand for this additional class of business. The creation of a demand for such forms of insurance as Rent, Use and Occupancy, Profit and Commission and Leasehold is as effective from an income producing standpoint as the building of new cities or even the development of new states. But we are not only interested in producing income, but of earning a profit on the business written, and it is therefore of importance that we should understand as clearly as possible what risk is undertaken so that we may judge whether it is desirable.

The extent to which the lessee can suffer by fire can only be decided when the conditions are known, and they are as various as the needs and desires of the two parties to the contract may require.

As far as possible all the facts should be known and certain of them should be incorporated in the policy. The application should recite the unexpired term of the lease and the monthly value of the leasehold over and above the rent paid, and insurance should be carried for an amount equal to the monthly value multiplied by the number of months in the unexpired term of the lease. The method of arriving at this value should be known, and if it is an estimated value, it should commend itself to your judgment as fair and reasonable.

The conditions under which the lease can be terminated in consequence of fire should be stated, and preferably the "fire clause" of the lease should be quoted in full and made a part of the contract.

The loss should be limited to the value for the unexpired term from the date of the fire, so that the amount collectible is reduced ratably each month during the continuance of the policy.

It is usual to provide, in the event of a fire rendering the premises untenable but not terminating the lease, that the Company shall pay an amount equal to the monthly value stated during the time the premises are untenable.

With this information and under these conditions, we must consider the probability of loss as we would the hazard of any undertaking, considering the construction of the building, its protective equipment, such as automatic sprinklers, the general fire hazard and what the probabilities are that a fire would damage the building enough to terminate the lease in accordance with its conditions.

When the premises, the subject of the lease, is a single floor, or loft, it may more easily be destroyed within the meaning of the contract and the risk is relatively less desirable.

If any damage short of total destruction is specified, the risk is greater, as the required extent of damage decreases.

Any lease giving the lessor the option of cancellation in consequence of a moderate damage is a very hazardous subject of insurance.

This entire subject is of great interest and of almost infinite variety and will well repay your further thought and study.

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